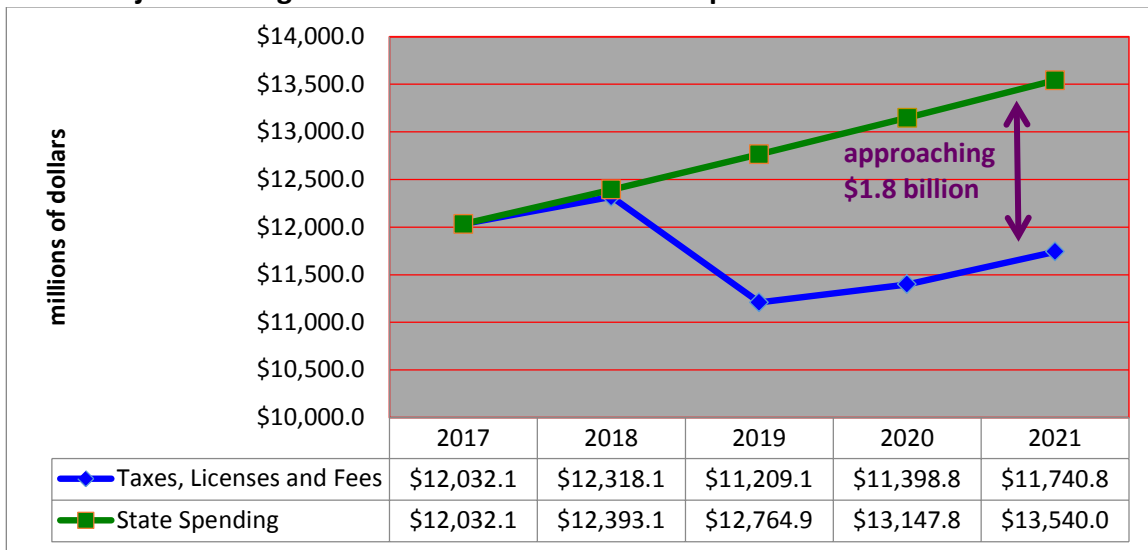


BUDGETARY BACKGROUND AND RECOMMENDATIONS:
SETTING THE STAGE FOR LONG-TERM FISCAL REFORM

Establishing the Fiscal Landscape

In the last two fiscal years the discrepancy between what the state apparently believes are important and necessary state expenditures and the revenues that were projected to be produced by the state’s tax structure have reached proportions that could not be solved by windfalls, fund sweeps, tilting the tax laws so as to expedite tax collections more quickly, or some other unexpected revenue sources. The degree and impact of this imbalance on revenues is illustrated in Figure 1 with temporary tax increases expiring as of June 2018.

Figure 1. Projected Budget Outlook Based on Current Expenditures and Tax Structure



The State Legislature recognized the necessity of meeting the challenges head-on in the 1st Extraordinary Session of the Louisiana Legislature in 2016 by creating the Task Force on Structural Change in Budget and Tax Policy. The Task Force has met on approximately 30 separate days from March through October, sought out and received written and verbal presentations reflecting different perspectives of the Louisiana budget from citizens, business and labor organizations, and local governments in a publicly broadcast forum, and reviewed volumes of data derived from multiple state databases.¹

This analysis is about more than just raising dollars for the state government to spend on public services; it is about aligning the manner in which revenues are raised to a more predictable and balanced structure; rebalancing revenue sources and empowering local governments to make them less dependent upon state government for local obligations;

¹ Directly due to the engagement and support of employees of multiple state agencies, including in particular the staffs of the Division of Administration, the Department of Revenue, and the Legislative Fiscal Office, the Task Force was able to request sorts, queries and multiple analyses of fiscal data. For these efforts, the Task Force is most appreciative and forever indebted, as it would have been impossible to conduct the Task Force’s work without their substantial knowledge, experience and support through this process.

untethering our income tax structure from adverse impacts resulting from decisions made in Washington D.C.; expanding our tax bases to make our state more competitive with other states; implementing ways of making the administration of state and local taxes more efficient and in line with “best practices” in other states; and facilitating further streamlining and reductions in the cost of providing governmental services. In pursuing these goals, it is recognized that change to an entrenched system is never easy or without challenges; therefore, where it was determined that prompt change would create unnecessary harm, a period for transition and alternative sources were identified to meet lost revenue. Additionally, because the revenue identified by the sources is uncertain; the transition will take time to implement. Throughout this process, cooperation among all stakeholders will be required to achieve a structure that will position our State for the next decade or longer to be more competitive, efficient and responsive to our collective needs without overburdening any sector of our population.

We will make it clear from the beginning that any major change in the delivery of public services or even in the downsizing of public services will not generate major savings in the short-run. This is not to say that structural changes in the public services offered by the state or in the way in which the state delivers them should not be examined, evaluated, and altered, but, rather, we just want to warn everyone that they should not expect an immediate reduction in expenditures from structural changes in public programs. This has been amply noted by the major change in the delivery of healthcare to persons in Louisiana that did not have access to healthcare. Closing state healthcare institutions and replacing them with private hospitals via cooperative endeavor agreements may and hopefully will save money and improve services in the long-run; in the short-run, it was not promoted as a method of balancing the budget. As a general rule, elimination of structural elements of a system is rarely, if ever, achieved with an immediate overall savings if a transition is to be successful.

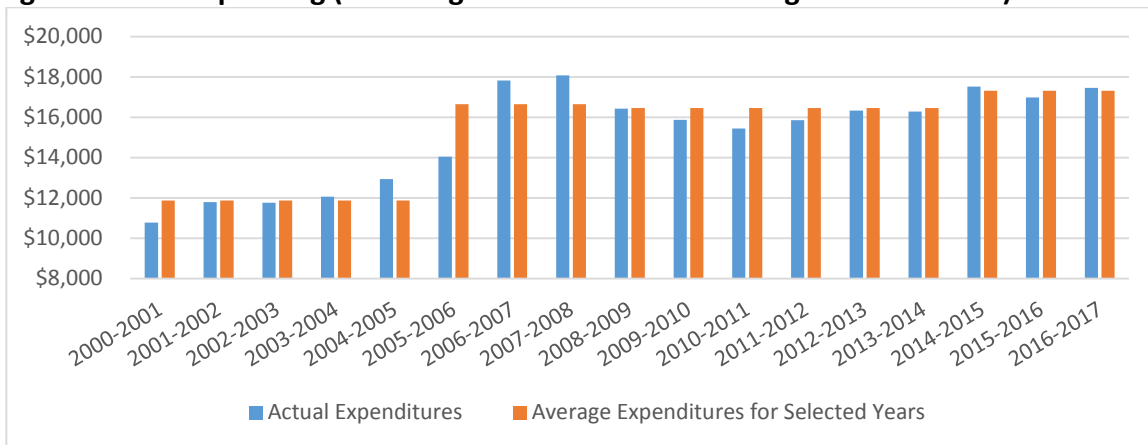
Examining Spending

Comprehensive state spending must be addressed as part of the solution for long-term fiscal sustainability. In Figure 2 we show all state spending, including all dedications and fees and self-generated funds. The only surge in state spending came in 2007 and 2008, but state spending fell in 2009 and has been, on average, relatively stable over the last seven years with very modest increases, though there may have been changes in priorities within the budgets. However, there has been an increase in our total state budget especially if we include federal funds, which is due to a substantial increase in federal funds that cannot be utilized for anything other than the identified purpose, which in most cases are roads, hospitals and healthcare. It is worth noting that Louisiana has been particularly successful in this regard by attracting the second highest amount of federal funding of all states.

The Task Force recognizes that the issue of state spending involves the amount of money the state spends on various government programs and the structure of priorities that are built into the state's dedications and spending mandates. Most of what the state spends

each year is obligated even before the Legislature begins the annual budget debate. The state's flexibility is tied by commitments and dedications made years ago. Some, if not many, of these dedications may stand the test of scrutiny year after year, but dedications do inhibit extra examination of each spending program.

Figure 2. State Spending (including all dedications and self-generated funds)



As an absolute guideline, the state must avoid budgeting practices that allow spending beyond the available recurring revenues. Also, the state should not create short-term spending or revenue-raising gains in exchange for greater long-term costs. These practices and budget gimmicks in recent years have had a profound and damaging impact on state fiscal stability, our state's credit and fiscal ratings, and ultimately resulted in an inefficient allocation and expenditure of resources. Furthermore, the appropriations process must be based on the most realistic forecasts of budget expenditures. In recent years, grossly inadequate targets for the real utilization of MFP school funding, Medicaid, and TOPS, have been used to give the appearance of a balanced budget at fiscal year-end, but have ultimately led to mid-year budget shortfalls as actual utilization has materialized over each of the last eight years. To reduce the potential for this occurring, the Task Force recommends establishing a formal multi-year spending forecast, a tool that some other states have found useful.

More efficient spending can possibly be addressed through the continued elimination, streamlining, consolidation or appropriate outsourcing of government services as an ongoing endeavor. The Commission on Streamlining Government issued a report in 2010 with 238 specific recommendations, many of which have been adopted and implemented. In 2014 the state commissioned a study by Alvarez and Marsal, *Government Efficiencies: Management Support*, which outlined different ways of cutting state expenditures. More recently, the Legislature passed House Concurrent Resolution 25 to compel state agencies to demonstrate efforts to become more efficient. The Task Force was not charged with conducting a detailed study of the proposed efficiencies and streamlining, but members

were provided with and reviewed the HCR 25 reports submitted by each agency. Some of the reports contain detailed and worthwhile initiatives even though they might not lead to transformative changes in state spending levels. In particular, the Task Force wants to commend the Board of Regents' report for a thorough review and listing of alternatives to encourage efficiencies and enhance the overall higher education structure.

Additionally, the Task Force notes that the Division of Administration, pursuant to Governor John Bel Edwards Executive Order JBE 16-05, and the Legislature have undertaken a comprehensive review of all state contracts to determine whether there are cost savings. Although not quantified, this effort has resulted in the cancellation of many state contracts; however, more significantly, this effort has revealed that many of the largest contracts are directly tied to the provision of vital public services. As such, these contracts cannot be cancelled and should not be cancelled, because these services were deemed to be provided more efficiently to the state through a contracted relationship and will yield either greater controls over costs or potentially savings in the long run. The Edwards Administration is continuing this process and implementing changes in state contracting wherever available as detailed further in the main report.

Much of state spending is determined in the Constitution by dedicated trust funds. Of the nearly 50 constitutional funds, about half make a significant impact on state spending or major government programs. Approximately three-fourths of these funds were created or substantially revised since the enactment of the Constitution of 1974. That is a rate of nearly one new fund per year. Constitutional provisions also serve to detour or restrict certain sources of revenue and to mandate various types of spending or savings. The long-term piecemeal approach of locking up state resources and obligating expenditures in the Constitution has raised anxiety that the state's fiscal structure lacks the flexibility to deal effectively with its most pressing financial problems. Certainly, the bulk of the fund management placed in the Constitution continues to align with current Legislative priorities. Still, in some cases, what was a budget priority in years past might not be seen as so vital today, and some new best practices may have come to light to better inform our state's policy. However, while the number of trust funds locked up in the Constitution is a matter for concern that should be avoided in the future; the vast majority of dedicated revenues in the Constitution are contained within funds dedicated to education and transportation, both of which are vital needs of the state.

The Task Force did not have the responsibility of reviewing individual constitutional funds and making specific recommendations for changes; however, the members recognize the dimensions of the problem and are prepared to suggest next steps. The Task Force recommends a new holistic review mainly of Article VII of the Louisiana Constitution, and related statutes, with the purpose of identifying consensus on changes that would improve the state fiscal structure, including potential revisions, elimination or mergers of funds. This initiative could take one of several forms, including a special legislative committee, a task force similar to the Louisiana Governmental Reorganization Commission further explained in the full report, or a constitutional convention limited in scope to Article VII and not on the entire document.

Additionally, the Constitution has been used to control the volatile revenue streams from oil and gas taxes, particularly through the Budget Stabilization Fund, or Rainy Day Fund. A proposed constitutional amendment on the Nov. 8 ballot would further control large surges in mineral and corporate income revenue. These types of controls can serve to stabilize revenue and government operational budgets over the long run and may also contribute to stronger credit ratings for the state. Whatever the result of the Nov. 8 election, this type of mechanism should be included in any review or convention dealing with constitutional changes. The goal would be to ensure the mechanism is simple, well protected and flexible enough to be practical while still serving the purpose of stability.

Statutory dedications also present a challenge and perhaps some opportunities. Numbering about 500, they reduce the ability of state policy makers to set priorities through the appropriations process. Many receive little scrutiny. However, eliminating statutory dedications does not create substantial new revenue or solve spending problems, especially if the dedications are adding value to the state or are already offsetting general fund expenses. The Task Force recommends staggered sunsets on all non-constitutional dedications by specific dates, with genuinely skeptical reviews to determine if they can be adjusted, eliminated or combined with others. This recommendation and a review of additional suggestions made by other groups are further discussed in the main report.

Among the state's most significant spending problem is the unfunded accrued liability (UAL) created by the state pension systems. The UAL is a more than \$20 billion debt that places a serious stress on the state budget, but arises from historically inadequate funding of the state pension system, which is a constitutionally established benefit to current and former state employees that takes the place of both a pension plan and Social Security for those who participate. Each year the state makes payments toward this UAL according to a long-term schedule, which for the two largest systems required less than \$600 million in 2006 but has grown to more than \$1.6 billion annually since then. A portion of the UAL is targeted to be paid off no later than 2029, due to a constitutional amendment mandating this that was passed in 1988. The money for the payments is drawn from funds appropriated or received by state agencies, colleges and school districts, which are obligated to fund the cost of maintaining this pension program. The UAL pension costs have soared to keep up with the escalating schedule, where now these agencies, colleges and school districts must pay the equivalent of more than 20% (for teachers) or 30% (for rank and file state workers) of each employee's salary in order to make their UAL contributions. Testimony and materials provided to the Task Force reveals that the structure of the program has undergone substantial legislative modification over the past decade to the point now where the primary problem associated with our pension program is limited to paying down the existing UAL and ensuring that we avoid the creation of new UALs through the utilization of sound projections and transparency into the costs associated with paying down this state obligation.

This report does not make recommendations regarding a restructuring of the pensions or a potential change toward a defined contribution system. Such an evaluation was beyond the scope of the Task Force's work. The Task Force neither called for such changes nor ruled them out. However, the Task Force recognizes that state leaders need to continue

evaluating those structures and looking for ways to anticipate and control state costs in the long run. Some of the potential long-term proposals, such as moving from a defined benefit to a defined contribution plan for new employees, would likely cost the state more in the short term compared with the current rate of normal costs. The Task Force questioned whether the current contribution level toward the pension normal costs is adequate to prevent further build-ups of UAL. As for future direction, the Task Force recommends that the state continue making its UAL payments without stretching the debt further over time for the purpose of short-term gain. Also, as the pension systems have demonstrated with their analysis, extra contributions toward the Initial UAL debt would show a strong return on investment for the state and could hasten the day when the Initial UAL can be retired, freeing substantial amounts of money for the state operating budget. The Task Force also would like to draw attention to the Legislative Auditor's recommendations for the pension systems and for the need to establish the most accurate possible rate of expected return for the pension investments. A lower expected rate of return would cost the state more in the short term but, if warranted, would make a sounder financial plan for the long term by limiting further the possibility of creating new UALs.

Tax credits, rebates, deductions and exemptions have the same effect as spending on the state's budget, because they reduce the revenues that would otherwise flow to the state for use in the state general fund. As such, while these mechanisms may and do, in some cases, serve a useful purpose, the number and value of these measures have grown remarkably and have placed an undeniable strain on the state budget by limiting receipts in many cases and actually requiring a direct payment from the state to the party claiming the rebate. Between 1990 and 2013, the Legislature added 34 credits and various exemptions to the corporate and franchise tax structure and 61 new measures affecting the individual income tax, 30 new sales tax exemptions, and 63 sales tax exclusions. Among those affecting taxes on sales, individual and corporate income, franchise and severance, the total value of these breaks between 2008 and 2015 grew 85% to \$7.3 billion and exceeded actual collections of the taxes themselves. This report addresses many of these programs and in many cases recommends elimination, revision, curtailment or increased oversight and regulation.

We caution the Legislature that in the absence of express provisions in the enabling legislation, these special tax provisions are essentially unconstrained and the growth of the exemption, deduction, or credit is not controlled by the State Legislature. Most significantly, resources utilized to satisfy a tax exemption, deduction, or credit will take precedence over the allocation of resources as described in HB 1 – the state operating budget.

Revenue Background

In 2015 and 2016, the state made significant increases in tobacco, beer, liquor and wine, and excise license taxes, as well as limiting multiple tax credits/offsets with particular attention to the inventory ad valorem tax credit.

Additionally, in 2016 the state raised the sales tax rate from 4% to 5% and expanded the sales tax base in Act 26 of the First Extraordinary Legislative Session; several changes were made to tax credits associated with the individual income tax; and an adjustment was made

to the horizontal drilling exemption associated with the severance tax on oil and natural gas.

These changes in 2015 were estimated to yield \$750 million in additional revenue in fiscal 2016 and the changes in 2016 were estimated to increase state revenues by approximately \$1.5 billion for fiscal 2017 and fiscal 2018.

The state is projected to collect \$12.032 billion in state taxes, licenses and fees in fiscal 2017 while at the same time the state is expected to allow \$7.71 billion of exemptions, deductions, and credits. The amount of the credits comprises 64% of total collections. In theory and assuming no changes in the behavior of the taxpayers, if there were not any exemptions, deductions or credits, state revenues would be approximately \$20 billion in state revenues, licenses and fees.

Many of the tax changes made in 2015 and 2016 were temporary in nature and will expire on June 30, 2018 at the end of fiscal 2018; thereby presenting a fiscal shortfall of over \$1.5 billion in fiscal 2019, which means there is an absolute necessity to amend the tax structure to fund the programs that the state believes are in the best interest of the state or to make appropriate reductions in state expenditures.

Choices, Options, and Recommendations

The objective of any revenue system is to be fair, simple, competitive with other states, and stable over the long-run. These qualities are best achieved with taxes that are broadly-based with low rates that do not play heavy favorites for or against a particular constituency. Exceptions, exclusions, credits, and deductions should be minimal, as each of these devices allows for the transference of the tax obligation to the individual or entity that is not receiving the benefit of the exception, exclusion, credit or deduction. This is not to say that all exceptions, exclusions, credits, and deductions are improper. Instead, the use of these devices should be tailored to meet a well-defined objective as identified by the Legislature, and administered and monitored to assure that the objectives are being achieved.

Because Louisiana's system is replete with exceptions, exclusions, credits and deductions, the Legislature must assess these devices with the understanding that for each such exception, exclusion, credit or deduction there is a cost to the state in reduced revenues and/or an increase in the rate and amount of tax paid by other taxpayers. In conducting this assessment, economic competitiveness and comparisons to other states, broad economic benefit, and job creation are all relevant factors for consideration.

In accordance with these basic principles, the Task Force makes the following recommendations which are designed to be holistic in impact. The Task Force's focused on sales tax, individual income tax, corporate income tax, and property tax, as well as the various exemptions, exclusions, deductions, and credits that are impact the revenues derived from these taxes. As a practical manner, we have to focus on one tax at a time when assessing an entire fiscal structure, but the changes in the entire tax structure that we

recommend should be examined globally in relation to one another. We strongly caution against a piecemeal approach.

Sales Tax Base and Rate

The pre-2016 sales tax base, including the sales tax on motor vehicles, produced about \$805 million in state revenue per penny. According to the 2015-16 Tax Exemption Budget over \$725 million per penny was not taxed because certain items are not taxed according to state law. Under our fiscal structure, local governments also rely heavily on the sales tax, because Louisiana does not allow for a local income tax and establishes fairly restrictive rules on property taxation by the local governments. With the addition of the sales tax changes during the 2016 Legislative Session, the combination of state and local Louisiana sales tax averages over 10%, giving Louisiana the highest state and local sales tax rate in the country. Because Louisiana has an economy that promotes tourism, the use of a sales tax allows for state revenues to be derived from non-residents to the ultimate benefit of residents; however, the state and local sales tax rate in Louisiana is higher than the sales tax rate utilized in states like Florida and Nevada, two states that are perhaps even more dependent upon a tourist-oriented economy.

As a predicate to our recommendations, we note that the Louisiana Tax Study, presented to the Legislature in 2015, called for the creation of a sales tax commission to make recommendations for a uniform sales tax collection process, rates and auditing. The Legislature did so with the creation of the Louisiana Sales Tax Streamlining and Modernization Commission, whose work has been underway for over a year working directly with all stakeholders to identify a way to move to a common sales tax base between state and local governments and this Task Force is fully supportive of those efforts. To provide this Commission with specific recommendations, the Task Force advises as follows:

The Task Force recommends (1) reducing the state sales tax rate to a minimum of 4.0% and preferably less as the revenues derived from a tax base expansion and eliminations of exemptions are quantified; (2) eliminating certain exemptions from the sales tax base to include items now taxed according to Act 26 passed in the 1st Extraordinary Session and amended by Act 12 of the 2nd Extraordinary Session; (3) expanding the sales tax base to include the same services that are currently taxed in Texas and digital products; (4) including non-residential utilities as part of the tax base; and, (5) including manufacturing machinery equipment as part of the state sales tax base but establish rebates in order to be competitive with other states. We make this suggestion regarding MME in order to maintain a common sales tax base with locals. We also suggest that, with the exception of non-residential utilities, any expansion of the state sales tax base also apply to the local sales tax base as well. It would be our suggestion that locals use any revenue enhancements to offset other reductions in local taxes or to lower the sales tax rate as appropriate. We cannot provide specific information regarding the allocations among each governmental subdivision in each parish.

The purpose of a low state sales tax rate is to keep Louisiana competitive with other states, while allowing local governments the ability to fund local programs from locally derived

revenue. This also reduces local government's need to seek state assistance. While some of the state sales tax exemptions relieve some of the tax burden on lower income households, the sales tax is regressive with respect to individuals and families. As we broaden the base, the allocation falls on businesses and higher income individuals to a greater extent than lower income individuals.

Additionally, the Task Force recommends that local and state government create a uniform sales tax base in a reasonable balanced, but expeditious manner. A common sales tax base is integral to improving the impression of Louisiana's sales tax policy as indicated in national comparisons which currently view our system as complex, inconsistent and more challenging to comply with than other states. Additionally, a uniform sales tax base will be helpful in allowing local governments to receive the benefit of sales taxes associated with online sales. While there are arguments in favor and against internet sales taxes, the shift to online purchasing from vendors such as Amazon is occurring at a rapid pace and our state and local governments are not receiving the sales taxes for these transactions. Notably, these are not new taxes, as a "use" tax already applies to these transactions; however, the state and local governments do not receive these revenues as the law intends.

One aspect of base unification focuses on common exemptions at the state and local level. In order to maintain a common state and local sales tax base for purposes of the Manufacturing Machinery and Equipment ("MME") exemption, we recommend imposing state and local sales tax on MME but with a state rebate of the tax and allowing local governments the option to provide such a rebate especially as other tax changes are made. Ideally, we would recommend the elimination of the state and local sales tax on MME but recognize the impact elimination would have on local government and believe that this mechanism will help move the state to base unification more quickly.

Sales Tax Administration

The Task Force recommends the state and local governments establish a uniform sales tax administration and collection system. Louisiana must streamline and standardize the sales tax collection system in terms of definitions, exemptions, exclusions, and auditing standards for the state and all local political subdivisions. These recommendations are based on making sales tax administration simpler for business tax compliance as well as minimizing the cost of administering and collecting the sales tax and making our sales tax collection system conform to the best practices followed by other states. The Task Force also recommends a recodification of the sales tax laws into a simpler, easier to follow format.

The ultimate goal and most effective way to achieve tax streamlining is to pass a constitutional amendment allowing a single, uniform state/local collection and auditing system, that would align Louisiana's practices with those used by other states that utilize state and local sales tax. If a constitutional amendment is not pursued, then alternative systems that would be effective in streamlining collections through newly created oversight bodies that take advantage of existing and developing technology and maintain the confidence of the local bodies whose budgets are dependent upon certainty of the revenue which flows from this source should be developed and implemented.

In making these recommendations, the Task Force does not imply that there is a single way to achieve this policy change or that any change can be accomplished in a short time frame; however, the Task Force does contend that improvements in the administration of the sales tax collections will benefit the state's economy and its competitiveness. To achieve this objective, the cooperation of state and the local governments is absolutely imperative in achieving this essential reform.

Individual Income Tax

The Task Force recommends two options for changes in the individual income tax structure. Option 1 will require a constitutional amendment approved by the people, while the Option 2 may be accomplished by legislative action. These are detailed in Table 1.

By design, the individual income tax is progressive and thereby offsets some of the regressivity of the sales tax. It is also a growth tax offsetting the fact that a number of other state revenue sources do not automatically grow with the economy. In terms of administration, the individual income tax is more cost effective than the sales tax or corporate taxes in terms of resources needed to administer the tax. The Task Force recommendations for the income tax proposals are consistent with best practices utilized by competitor states, in defining the income tax base and in establishing rates that are within ranges used by these states; thereby creating an individual income tax system that is simpler, more transparent and more competitive than our current system.

Option 1 provides for an expanded tax base with narrowed brackets, and a 25% rate reduction.

Option 2 provides for an expanded tax base with narrowed brackets; however, there will be no rate reduction because the federal tax deduction is retained in the Constitution.

Additionally, the Task Force includes in Table 1 recommendations for the elimination or retention of certain exclusions, deductions and credits.

The Task Force recommends that the individual income tax and the sales tax be structured to provide approximately the same amount of revenue to support the state's budget as this allows the state to keep the rates for both the sales tax and the income tax as low as our identified revenue requirements allow. This also provides fair treatment across income brackets, because lower income households pay a larger share of their income in sales taxes and higher income households pay a larger share of their income in income taxes. Both taxes are taxes that grow with the economy; however, the individual income tax has a slightly higher elasticity than the sales tax.

Table 1. Individual Income Tax Recommendations		
Tax Characteristics	Constitutional	Statutory
		Lower Rates; adjust brackets; and expand tax base
Rates and Brackets (single filer in parenthesis)	1.5% on first \$25,000 (\$12,500 single) 3.0% on \$25,000 through \$50,000 (\$12,500 through \$25,000 single) 4.5% above \$50,000 (above \$25,000 single)	2.0% on first \$25,000 (\$12,500 single) 4% on \$25,000 through \$50,000 (\$12,500 through \$25,000 single) 6% above \$50,000 (above \$25,000 single)
<u>Eliminate</u> exclusions and deductions	Federal Tax Liability 50% of Excess Itemized Deductions \$6,000 Retirement exclusion	Excess Itemized Deductions \$6,000 Retirement exclusion
<u>12/31/2019 Sunset</u> Exemptions and Deductions—re-evaluate so changes, if necessary, can be made. Enhanced Oversight by Legislature with specific expectations about accomplishments of special tax advantages	Net Capital Appreciation \$25 Education Credit Quality Public Education Home-Schooled Children Recreation Volunteer Volunteer Firefighter IRC Section 280C Expense	Net Capital Appreciation \$25 Education Credit Quality Public Education Home-Schooled Children Recreation Volunteer Volunteer Firefighter IRC Section 280C Expense
<u>Eliminate</u> Tax Credits	Citizens Property Tax Credit	Citizens Property Tax Credit
<u>Allow to Expire in 2018</u>	Solar Credit	Solar Credit
<u>Re-evaluate in 2021</u>	Historic Tax Credit	Historic Tax Credit
LED's Programs—will examine as group	See discussion at p. 15	See discussion at p. 15
Property Tax Credits—to be examined in property tax section	See discussion at p. 13	See discussion at p. 13

Corporate Income and Franchise

During the legislative sessions in 2016, several important steps were taken to reform the corporate income tax for Louisiana. These reforms were precipitated by the Louisiana Tax Study in 2015 and the Tax Foundation report from C100, as well as other prior reports and our ongoing discussions of tax reform.

The Task Force recommends the elimination of the deduction for federal taxes paid for the corporate income tax as included on the ballot on November 8, 2016. This decouples the Louisiana tax base from federal tax changes and provides the opportunity to lower the corporate tax rate to 6.5%. While the Task Force acknowledges that there is no perfect way to address corporate taxation, this approach provides a reasonable approach that will better align Louisiana with its competitor states, potentially provide for a more stable source of revenue than the current corporate income tax structure, and eliminate any instability in state corporate tax collections due to actions in Washington, DC.

The Task Force commends the Legislature and Governor for several major improvements in the determination of the corporate income tax base including (1) the add back statute, (2) methods used to apportion the income of corporations within and outside Louisiana, and (3) market sourcing of services. These are all methods to better define the corporate tax base which provides stability for corporations as well as the state. The Task Force recommends a careful evaluation by the Louisiana Department of Revenue and the Louisiana Tax Institute of a move from single-entity taxation, as we currently have, to a system of combined reporting to further assist in creating a simpler more predictable source of revenue for the state.

Because the corporate franchise tax as it is utilized in Louisiana differs substantially from how it is used in other states, the Task Force recommends restructuring, phasing out or eliminating the Corporate Franchise Tax provided the replacement revenue source to coincide with that restructure, phase out or elimination is identified. The determination of the appropriate restructure, elimination or phase out would be through a study conducted by the Louisiana Department of Revenue and the Louisiana Tax Institute. The appropriate timeframe for any phase out or elimination will also be determined by the study. The study of the franchise tax and the combined reporting evaluation are to be completed within two years and recommendations are to be made to the Legislature based on the findings by 2019.

With respect to exclusions, deductions, and credits applicable to corporate income and franchise taxes, the Task Force makes the recommendations set forth in the Table 2. However, it should be noted that several exemptions and credits are really not corporate income tax issues, but instead pertain to other areas of the state's tax structure. Key examples of this are the inventory ad valorem tax credit and the economic incentives utilized by Louisiana Economic Development.

At the present time, the Task Force recommends that all temporary changes enacted during the 2015 and 2016 Legislative Sessions be allowed to sunset in 2018 in favor of the implementation of the permanent adjustments that are being recommended herein.

Table 2. Corporate Tax Exemptions, Deductions, and Credits			
Subchapter S	<u>Maintain</u>	Inventory Tax	
Net Operating Loss	<u>Maintain</u> and remove 72% cap	Offshore Vessels	Property Tax Issues; discussed separately
School Readiness Credit	<u>Maintain</u>	Other Telephone Companies	
Federal Tax Deduction	<u>Eliminate</u>	Natural Gas	
Donations to School Tuition—can also be individual income tax deduction	<u>Expanded Legislative Oversight</u>	Motion Picture Credit and other associated credits	LED Issues; discussed separately
Interest and Dividend Income	Study by LDR and Tax Institute due by 2019	Enterprise Zone	
		Quality Jobs	
		Other LED Programs	

Property Tax Reform

The property tax is a local tax though the state has the constitutional authority to levy an ad valorem tax of 5.75 mills. There are several major exemptions related to the property tax and an established assessment process built into the state constitution. Land and residential improvements are assessed at 10% of fair market value; industrial and commercial property at 15%; and public service property at 25%. Farm and timber property are taxed on use value as opposed to fair market value.

The homestead exemption was increased to \$7,500 as of 1982 and has not been increased since that time. Over the last 36 years the relative value of the homestead exemption has diminished due to rising home prices and property taxes paid by residential property owners have gone up. In 1990 and in 2015 homesteads made up just about half of all property taxpayers. In 1990 the Louisiana Tax Commission noted that 83% of all owner-occupied homesteads were tax-free since the assessed value of their homes did not exceed \$7,500, while in 2015 only 38% of the homesteads were tax-free. The appropriate policy is to maintain the present homestead exemption.

The Industrial Tax Exemption has increased in value since the market price of industrial expansion has risen. This exemption has an economic development value, but the plants and facilities also require public services. This is an exemption controlled by the state though the dollars given up are local revenues. The Task Force recommends that local governments have a role in granting the industrial tax exemption. As such, the Legislature should adopt a resolution amending the industrial tax exemption in the Constitution to allow for local governmental approval of the exemption and creating a statutory framework for the exemption that ensures local governments are included in the approval process and establishing policies for use of the exemption as an economic development tool that favors job growth. Further, the following guidelines could be included in the statutory framework: the industrial exemption can be up to 100% of the value of the investment for the first five years and then up to 80% for the next three years.

The Task Force recommends a constitutional amendment to allow for a gradual elimination of the assessment of ad valorem taxes on inventory over a ten-year time period accompanied by an elimination of the state income and franchise tax credit for ad valorem taxes paid on inventory over a five-year time period. The constitutional amendment for the elimination of the ad valorem tax on inventory should include a provision to allow for a roll-up of existing millages to offset the revenue reduction. In lieu of the millage roll-up to offset the revenue reduction, the Legislature should consider enhanced sources of local revenue from changes to the local tax base including but not limited to changes to the industrial tax exemption or expansion of the sales tax base. Another alternative to offset the revenue reduction would be the creation of a temporary revenue sharing fund. The offsets to address any revenue reductions should consider the impact of the inventory tax elimination on each local governmental subdivision currently collecting the tax.

The Task Force recommends the elimination of the ad valorem tax credit for natural gas over a five-year period. The Task Force recommends that the tax credits associated with offshore vessels and other telephone company property be maintained presently, but that special committees, such as the SCR 6 Task Force, examine other methods of dealing with these unique ad valorem situations. The present method of the state picking up the tab needs to be reassessed.

The Task Force further recommends expanded use of payment in lieu of tax ("PILOT") arrangements for local governments considering ad valorem tax exemptions to attract economic development and that the Legislature consider legislation deemed appropriate to expanding this opportunity. Any such use of PILOT arrangements should require a resolution of the elected officials in the taxing jurisdiction in addition to any appointed board, such as an industrial development board.

The Task Force recommends a constitutional amendment limiting the ad valorem tax exemption for property owned by non-profits to property exclusively used for the tax exempt purposes of the non-profit. This recommendation would still allow for a complete exemption of property owned by religious entities and an apportioned treatment of non-profit owned property that is not exclusively used for the tax exempt purpose of the

organization. Other states have implemented an apportionment model to allow for a partial exemption of the property.

LED Development Incentives

The Task Force recommends that the Louisiana Department of Economic Development (“LED”) establish sunsets and review periods for all of its programs, other than as set forth herein. This has been recommended by national organizations like the Pew Charitable Trusts, as a way to ensure fiscal responsibility and effectiveness of incentive programs. Most of LED’s programs already have established sunsets, in which the department will have to file legislation in the 2017 and 2018 Legislative Sessions to extend the sunsets. For example, the Quality Jobs (“QJ”), Enterprise Zone (“EZ”), Angel Investor (“Angel”), and Research and Development (“R&D”) Programs will require legislation to extend sunsets in 2017 or 2018.

The Task Force recommends that LED continue to monitor and regularly report on the performance of all of its programs. The reporting must include information on the return on investment for each program in terms of both the fiscal impact and the economic impact and other metrics relevant to program performance. Rigorous studies are required to examine tax incentives. We suggest that these studies must follow three general guidelines.

First, the studies should be conducted by independent parties without a vested interest in the specific conclusions of the studies. This means that the economic development agencies or the business lobbying groups should not conduct these studies. Instead, the studies should be contracted out to disinterested parties with strong track records in conducting similar studies using best practices from other states’ studies.

Second, the studies should recognize that using taxpayer funds for tax incentives means that these same taxpayer funds cannot be used for other government programs. An implication of this guideline is that the studies should be prudent in conclusions that rely upon the “multiplier” effects of the amount of an incentive in assessing the fiscal impact of the tax incentive. Tax incentives are one form of government spending, and generally any government spending generates multiplier effects. A dollar spent by state government on, say, school construction will generate additional economic activity through a multiplier effect, just like a dollar given by state government to businesses using a tax incentive will generate additional economic activity via a multiplier effect. Assessing the viability and benefit of an incentive program primarily based on its multiplier effects can overestimate the economic impact of the incentive program relative to other spending programs. A further implication of this guideline is that the studies should make symmetric use of multiplier effects in assessing the fiscal impact of any program.

Third, the studies should recognize that many businesses may expand or re-locate without the tax incentives. This means that the studies should not use a “but for” methodology that assumes all new activity is generated by tax credits. Instead, the analysis should assess the programs relative to the legislatively identified objectives with recommendations for how

the programs can be modified to achieve these objectives.

Recommendations on specific programs

The Task Force recommends that LED revisit the wage requirement (\$14.50/hour) of the QJ Program. The wage required for program eligibility should be adjusted periodically to keep pace with the growth of the economy. No other changes are recommended for this program at this time.

It is recommended that LED restructure the R&D program from a 40% tax credit to a 30% rebate, limit participation to only companies that receive a federal Small Business Innovation and Research (SBIR) grant, and cap this program at \$5 million per year. Simultaneously, the existing uncapped 40% R&D tax credit program should be eliminated.

The EZ Program underwent significant reform in the First Extraordinary Session of 2016. The program has been capped and the jobs credit has been redesigned to reward the hiring of economically disadvantaged Louisiana citizens. These changes will result in an estimated \$26 million in savings by fiscal year 2020. No further changes are recommended for the EZ program. The Task Force recommends that the program's performance be continuously monitored as the reforms begin to show results.

It is recommended that LED establish program sunsets of July 1, 2021 on all of its tax credit incentives and July 1, 2022 on all of its tax rebate incentives. It is recommended that LED identify to the Legislature all underutilized or inactive programs so that they may be eliminated.

Motion Picture

The Motion Picture Investor Tax Credit Program ("MPIC") underwent extensive reform in the 2015 Legislative Session, which introduced new tools for LED, as well as the inspector general to further inhibit the potential for fraud and abuse. Additionally, a back end cap of \$180 million/year was established and a one year suspension of the buyback option was implemented. LED has been tasked to develop further recommendations for reform for introduction during the 2017 Legislative Session. The department has a strategic plan currently under development to accomplish this goal. The desired end result is a program which achieves sustainability and predictability, an improved return for the State, and a statewide economic impact.

The Task Force recommends that the MPIC be retained as a non-appropriated, non-refundable tax credit incentive with both discounted redemption and transferability as alternative options for use. The back end cap established during 2015 should be eliminated in its entirety and replaced with a legislatively enacted front-end cap to mitigate the state's exposure to tax credits going forward. The State should implement a modification to the initial certification process to allow for a project to count against the cap only after it commences active production. This will allow the State to have control over the number of credits issued from inception. Coupled with other mechanisms that

would target specific types of production and potentially encourage reasonably timely utilization of credits, the potential for another backlog of credits that would materially impact the state fisc may be avoided.

The current review of the program by LED at the direction of Governor John Bel Edwards, which includes outreach to the industry, is supported and it is recommended that the outreach to the industry be incorporated into the oversight of the program through the reinstatement of the Film Commission. The biennial review of the program should be revised to include a report that specifically addresses the progress of the program with respect to each objective identified by the Legislature, especially with regard to building a stronger, more self-sustaining Louisiana motion-picture industry, as well as newly identified benefits of the program with a focus on accomplishing an acceptable return on investment.

State-local Relations

The first step in dealing with the state and local division is to create a fiscal structure for local governments that will allow local governments an opportunity to financially handle their responsibilities. Sales tax reform and property tax reform are essential if local governments are to have the capacity to raise sufficient revenues to provide for themselves and not have to depend on the state. The State should allow local governments to increase their sales tax rate without a vote of the Legislature; instead, only require a vote of the people in the area that will be subject to the new tax rate. The State should also consider reducing some of its commitment to local government as locals are given more authority to raise revenues and those revenues are collected.